**Slaughter and May Podcast**
**Tax News Highlights: December 2022**

| | |
|---|---|
| **Zoe Andrews** | Welcome to the December 2022 edition of our tax news highlights podcast. I am Zoe Andrews, PSL Counsel & Head of Tax Knowledge. |
| **Tanja Velling** | And I am Tanja Velling, Senior Professional Support Lawyer in the Tax department.<br><br>In this podcast, we will cover the UK's most recent new tax treaty, some highlights from the Autumn Statement and the Finance Bill and two recent decisions, the Court of Appeal's decision in *Centrica* and the Upper Tribunal's decision in *Kwik-Fit*. We will also provide an update on the UK's proposed replacement of its scaled-back DAC6 implementation and the National Audit Office Report on the Digital Services Tax.<br><br>This podcast was recorded on the 13th of December 2022 and reflects the law and guidance on that date. |
| **Zoe Andrews** | The UK has signed its first comprehensive tax treaty with Brazil – which has been a long time in the making! Following several years of discussions on technical and policy issues, Brazil and the UK announced a first round of negotiations in September. Things must then have progressed rather quickly, given that the treaty was signed on the 29th of November 2022.<br><br>But we can't get too excited yet – the treaty hasn't yet entered into force and no date for this has been given. In fact, when I looked at some other treaties that the UK has with countries in Latin America and the Caribbean, I noticed that, while the treaties were generally brought into effect within a few months, it took three years for the UK's treaty with Colombia to come into effect. Let's hope it doesn't take as long for the Brazil Treaty!<br><br>Anyway, we should probably also discuss what is actually in the treaty. Do you want to mention three highlights? |
| **Tanja Velling** | OK, so, first, withholding taxes on interest and dividends are generally capped at 15% (or a lower rate in some circumstances), but they are not eliminated. A notable exception to this is payments to pension schemes where no withholding tax would apply.<br><br>Second, the treaty contains an article which specifically deals with fees for technical services, meaning managerial, technical or consultancy services. The article is modelled on Article 12A of the United Nations Model Double Taxation Convention between Developed and Developing Countries. It permits the service recipient State to withhold tax from fees paid to the service provider State at a rate of 8% for the first two years and 4% for the second two years. Thereafter, the withholding is switched off. |

| | |
|---|---|
| | Third and finally, I wanted to mention “Offshore Activities” which also have their own article. Broadly speaking, the exploration or exploitation of, or extraction of natural resources from, Brazil’s or the UK’s seabed or subsoil will create a deemed permanent establishment there. More generally, income derived from exploration, exploitation or extraction rights or gains from their alienation may also be taxed by the State where the relevant seabed or subsoil is located. |
| **Zoe Andrews** | Neither the OECD nor the UN Model treaties include an equivalent provision. The OECD’s commentary on the model permanent establishment article notes that since “it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provision”. Indeed, the UK is identified as one of the States to “reserve the right to insert in a special article provisions” related to offshore hydrocarbon exploration and exploitation and related activities in light of the special problems in applying the provisions of the OECD’s model treaty to them.<br><br>Given the importance of the issue to the UK and the fact that Brazil is South America’s largest oil producer with production being predominantly offshore, it is unsurprising that special provisions on offshore activities have been made in this treaty. A few more observations on the treaty can be found in Tanja’s post on the European Tax Blog. |
| **Tanja Velling** | The key message from the Chancellor on the 17th of November when he made his Autumn Statement was that those with more are asked to contribute more. Most of the announcements related to future changes although there was one anti-avoidance measure announced with immediate effect which prevents CGT avoidance by non-UK domiciled individuals using certain share for share exchanges or schemes of reconstruction carried out on or after 17 November 2022.<br><br>There will be two Finance Bills to implement the announced measures. The more technical measures (such as the implementation of the Pillar 2 income inclusion rule and a domestic minimum tax) will be included in the Spring Finance Bill whereas the Autumn Finance Bill published on the 22nd of November will implement a number of less technical revenue-raising changes including tax rate increases, threshold freezes (or threshold lowering in the case of the income tax additional rate threshold), the reduction of the dividend allowance and a reduction in the capital gains annual exempt amount. |
| **Zoe Andrews** | The Autumn Finance Bill also contains changes to Research and Development (R&D) Tax reliefs and to the Energy (Oil and Gas) Profits Levy. |

| | |
|---|---|
| | R&D reliefs are being reformed as part of an ongoing review. The Autumn Finance Bill provides that for expenditure on or after 1 April 2023, the Research and Development Expenditure Credit (or RDEC) rate will increase from 13% to 20%, the small and medium-sized enterprises (SME) additional deduction will decrease from 130% to 86%, and the SME credit rate will decrease from 14.5% to 10%. This reform is described as ensuring that taxpayer support is as effective as possible, improving the competitiveness of the RDEC scheme, and is a step towards a simplified, single RDEC-like scheme for all. As Kasim Mehmood points out in his blog post on the R&D changes, they signal a move away from focussing support in this area on SMEs towards broader support for larger companies which engage in R&D activity.<br><br>As previously announced at the Autumn Budget 2021, the R&D tax reliefs will be reformed by expanding qualifying expenditure to include data and cloud costs, refocusing support towards innovation in the UK, and targeting abuse and improving compliance. These changes will be legislated for in the Spring Finance Bill 2023. |
| **Tanja Velling** | The Autumn Finance Bill makes changes to the Energy (Oil and Gas) Profits Levy from the 1st of January 2023, raising the levy rate by 10 percentage points to 35% and extending the Levy to the 31st of March 2028. There is no longer an expectation that, should the oil price return to a more normal level the levy might end sooner so we no longer need to worry about what a more normal price is! |
| **Zoe Andrews** | No fiscal event is complete without the announcement of a new tax. This time it is an Electricity Generator Levy (EGL) which is a temporary 45% tax (which applies until the 31st of March 2028, aligned with the end of the Energy Profits Levy) that will be levied on extraordinary returns from low-carbon UK electricity generation. For the purposes of the tax, extraordinary returns will be defined as the aggregate revenue that generators make in a period from in-scope generation at an average output price above £75/MWh. The tax will be limited to generators whose in-scope generation output exceeds 100GWh across a period and will only then apply to extraordinary returns exceeding £10 million. The tax will apply to extraordinary returns arising from the 1st of January 2023 and will be legislated for in the Spring Finance Bill 2023 although draft legislation was promised by "mid-December".<br><br>And it's good news for financial services (for once!) as it was confirmed that following the decision to proceed with the corporation tax rate increase to 25% from April 2023, the changes to the Bank Corporation Tax Surcharge which are already legislated to take effect from the same point will also go ahead. So, from April 2023, this means banks will be charged an additional 3% rate on their profits above £100 million – meaning that they will continue to pay a higher combined rate of corporation tax than most other companies, and a higher rate than they did previously (so, 28% rather than |

| | |
|---|---|
| | 27%) but not as high as if the surcharge remained at the current 8% level. There was a rumour that the banks could also be subject to a windfall tax but thankfully this did not materialise. |
| **Tanja Velling** | Another consequence of the Corporation Tax rate increasing to 25% is that the rate of Diverted Profits Tax will increase from April 2023 from 25% to 31%. This is in order to retain a 6-percentage point differential above the main rate of Corporation Tax, and therefore ensure that it remains an effective deterrent against diverting profits out of the UK.<br><br>What happened with the consultation on whether to introduce an online sales tax (or OST)? |
| **Zoe Andrews** | It was announced in the Autumn Statement that there will not be an OST following the consultation. The government's decision reflects concerns raised about an OST's complexity and the risk of creating unintended distortion or unfair outcomes between different business models. We are still awaiting the response to the OST consultation which the Autumn Statement said would be published shortly but there was so much wrong with the proposal, from a technical and policy perspective it is not surprising it has been abandoned.<br><br>What's new on the UK's implementation of Pillar Two? |
| **Tanja Velling** | We await the Spring Finance Bill 2023 for the UK's implementation of the global minimum corporate tax rate of 15%. For accounting periods beginning on or after the 31st of December 2023 the government will introduce two rules.<br><br>The first we already knew about from the draft Finance Bill legislation published earlier this year. This is the Income Inclusion Rule which will require large UK headquartered multinational groups to pay a top-up tax where their foreign operations have an effective tax rate of less than 15%.<br><br>The second is a supplementary Qualified Domestic Minimum Top-up tax rule (QDMTT) which will require large groups, including those operating exclusively in the UK, to pay a top-up tax where their UK operations have an effective tax rate of less than 15%.<br><br>Both the IIR and QDMTT will incorporate the substance based income exclusion that formed part of the G20-OECD agreement. Adopting the QDMTT at the same time as the IIR is a new development, but it makes sense to have the QDMTT from the start.<br><br>The government intends to implement the backstop Undertaxed Profits Rule in the UK, but with effect no earlier than accounting periods beginning on or after the 31st of December 2024. |

| | |
|---|---|
| | Shall we look at some cases now? |
| **Zoe Andrews** | Sure. *Centrica* concerns the question to what extent expenses associated with the disposal of a loss-making investment are deductible as investment management expenses under section 1219 of the Corporation Tax Act 2009.<br><br>COHL, an intermediate holding company in the Centrica group, was invested in the Dutch Oxxio business. Following Centrica plc’s decision in June or July 2009 that Oxxio should be disposed of, it was accounted for as “held for sale”. The sale process was, however, rather lengthy. Between July 2009 and early 2011, COHL incurred certain bank, accountancy and lawyers’ fees on advice ranging from strategic considerations of how best to realise the investment to the drafting of the sale documentation. Finally, in February 2011, Centrica plc’s board approved in principle a particular third-party offer for the Oxxio business and the transaction completed in March of that year. |
| **Tanja Velling** | At first instance, the FTT decided broadly that no deduction was available to COHL on the basis that the expenses did not relate to its investment management business because all of the decisions were made by Centrica plc. The Upper Tribunal disagreed with this view and the point was not pursued before the Court of Appeal.<br><br>So, the only two questions were, one, whether the fees were “expenses of management” and, two, whether they were “expenses of a capital nature”. On the first question, the Court of Appeal broadly followed the FTT’s alternative reasoning and the Upper Tribunal. Expenses incurred in deciding whether or not to dispose of an investment (or indeed whether to acquire one) are expenses of management. Implementation expenses are not. So far, so good.<br><br>Both the FTT’s alternative reasoning and the Upper Tribunal then applied a rather similar test to determine whether any of the fees that had passed the management expenses test should nonetheless be non-deductible because they were of a capital nature. According to the Court of Appeal, this was where both had fallen into error.<br><br>Whether expenses are of a capital nature is to be determined in the same way in the context of an investment management business for the purposes of section 1219 as in the context of a trade for the purposes of section 53 of the CTA 2009. This then brings into play existing case law on the capital versus revenue distinction in relation to trading expenses and, having, cited this case law, the Court of Appeal concluded that all of the fees at issue here were of a capital nature and therefore non-deductible. Now, where does this leave us? |

| | |
|---|---|
| **Zoe Andrews** | Not very hopeful of getting tax deductions for transaction-related expenditure under section 1219?! In particular given that the classification of the expenses as capital or revenue is a pure point of law – which I find rather curious in and of itself as such a classification would seem to require a more or less detailed review of the facts – it is unfortunate that the Court of Appeal has not spelt out its reasoning in more detail. On the facts, the commercial decision made by Centrica plc in the summer of 2009 to dispose of the Oxxio business that resulted in the change of accounting treatment seems to have been crucial and may be a way of distinguishing other circumstances where costs are incurred while the intention to dispose of an investment is less firm.<br><br>It remains to be seen whether this case makes it to the Supreme Court. It would certainly be welcome, if the Supreme Court could provide further clarification on the applicable test and why particular items fall on one side of the capital versus revenue divide rather than the other.<br><br>And what about *Kwik-Fit*? |
| **Tanja Velling** | The Upper Tribunal's decision dated the 25th of November dismissed the appeals of Kwik-Fit and HMRC and upheld the decision of the FTT on the application of the unallowable purpose rule in section 441 of the Corporation Tax Act 2009 to a number of intragroup loans in the Kwik-Fit group.<br><br>Speedy, a company in the Kwik-Fit group had a carried forward non-trading loan relationship deficit (an NTD) which it was estimated would take 25 years to utilise. A reorganisation of intra-group loans was carried out (involving loans being assigned to Speedy, or in one case, created in place of an original loan and the interest rate on existing loans being increased to an arm's length rate) which resulted in more interest being received by Speedy. This enabled Speedy to use £48m of its NTDs within three years instead of over 25 years. There was no increase in overall group indebtedness but a higher rate of interest was paid by the debtor companies than was paid before the reorganisation and Speedy received greater interest payments. It was agreed that acceleration of the use of the NTDs was a purpose of the reorganisation. |
| **Zoe Andrews** | The UT concluded that the FTT had not erred in holding that the appellants each had an unallowable purpose in becoming parties to the relevant loans. Speedy had an unallowable purpose of using NTDs to offset against interest income and the debtor companies had the unallowable purpose of securing deductible debits for themselves (even if they were loss-making themselves). The FTT's decision clearly showed it was satisfied that a tax advantage was secured for identified persons, Speedy and each debtor company. The UT agreed that a company can have a purpose even if that |

| | |
|---|---|
| | purpose is ultimately unsuccessful. On the facts of the case, it was open to the FTT to find the unallowable purposes were “main” purposes. |
| **Tanja Velling** | *Kwik-Fit* is an important case for its extension of the meaning of “tax advantage” to include any combination of circumstances where the taxpayer is better off as against HMRC. The increased interest received by Speedy constituted a tax advantage in combination with the pre-existing NTDs. The purpose of the scheme included increasing debits (as the flip side or “twin element” of the increased interest). So in addition to the (good) original commercial purpose for the borrowing the debtors also had a bad purpose of increasing debits.<br><br>The UT concluded that the FTT had not erred in the application of the just and reasonable attribution provisions in section 441 CTA 2009. The exercise of attribution is rooted in an objective assessment of the facts and circumstances. Accordingly, the UT agreed with the FTT that all of the interest on the new loans should be disallowed, but for the pre-existing loan with Speedy and the loans assigned to Speedy, only the interest above the original amounts was attributable to the unallowable purpose. |
| **Zoe Andrews** | Fortunately, reforms in 2017 to the group relief rules to permit the surrender of NTDs mean such schemes to accelerate use of NTDs would no longer be used. However, the extension of the meaning of tax advantage and the “twin element” of increasing debits and increasing interest are of wider application.<br><br>We await the appeal to the Upper Tribunal in *JTI Acquisition Company*, expected next year, for the next instalment of unallowable purpose case law! |
| **Tanja Velling** | Anything else you wanted to mention before we move on to what to look out for? |
| **Zoe Andrews** | Yes! During the November edition of this podcast we had speculated whether the UK’s signing of a Multilateral Competent Authority Agreement in relation to the OECD’s “Model Mandatory Disclosure Rules on Common Reporting Standard Avoidance Arrangements and Opaque Offshore Structures” might mean that we would soon have an update on the UK’s plan to replace its scaled-back implementation of DAC6 with rules more closely modelled on the OECD’s Model Mandatory Disclosure Rules.<br><br>Well, we did not get an update as part of the Autumn Statement, but quite quickly thereafter. On the 30th of November, HMRC published the summary of responses to its 2021 consultation on the replacement rules. There are two main points to highlight. The good news is that the look-back period will not be extended beyond the June 2018 start date that applied for the DAC6 implementation. In less good news, the Government has decided against allowing manual reporting; all reports will have to be made in XML file |

| | |
|---|---|
| | format, meaning that businesses may have to buy or develop new software to make reports.<br><br>An updated draft of the proposed replacement rules has not been published and it is unclear whether or not there will be a further consultation on updated draft rules. The consultation response merely states that the new rules "will come into force in the first half of 2023", but the precise date is yet to be determined. |
| **Tanja Velling** | During our last podcast, we also referred to Public Accounts Committee inquiry into the UK's Digital Services Tax. The related National Audit Office report on its investigation into the DST was published on the 23rd of November 2022. It covers the operation of the DST during the first year when it was in force and contains some interesting insights.<br><br>During the first year, 18 business groups paid DST, but with 90% of the total tax take attributable to just five of them. The total DST-take from these 18 in-scope business groups was roughly equal to their total corporation tax bill. But there were significant variations between the business groups – the figures in the report indicate that, on the one end of the spectrum, three groups paid only DST and no corporation tax. At the other end of the spectrum, there were three groups that paid between 13 and 19 times more corporation tax than DST. Whether this is because of the different geographical scope or the different tax base is not entirely clear to me. |
| **Zoe Andrews** | It is also interesting that HMRC collected 30% more DST than forecast. The reasons include that in-scope businesses did not change their behaviour to reduce DST liabilities as HMRC had expected and that a small number of groups paid far more than expected as a result of the increased use of online marketplaces and social media during COVID.<br><br>So far, HMRC has not identified any non-compliance for the first year during which the DST has been in effect and, according to the NAO report, stakeholders had a broadly positive experience when interacting with HMRC in relation to the DST.<br><br>After an initial assessment which had identified 31 business groups as potentially within scope, HMRC found that a larger number could potentially be liable to DST. For the 2020-21 tax year, HMRC carried out pre-return risk assessments with 101 groups, including ones that lack a physical presence in the UK. The NAO report notes a number of potential compliance challenges in case any of those groups were to have a DST liability and prove uncooperative.<br><br>The NAO also asked HMRC about the impact of Pillar One on DST receipts, but the answer was that this is too early to tell – not least because |

| | |
|---|---|
| | a number of design questions have not yet been settled at the OECD level. Do you know when we will likely to hear more? |
| **Tanja Velling** | We are actually expecting an update from the OECD before Christmas on the reallocation of a portion of companies' profits to other countries and the definition of DSTs and other similar measures that are to be rolled back under Pillar One.<br><br>We are also expecting guidance from the OECD on the implementation of Pillar Two and, in the UK, we are waiting for the draft legislation for inclusion in the Spring Finance Bill on the Electricity Generator Levy. I also wonder whether we might see draft legislation for the UK's domestic minimum tax before Christmas, but this might be more likely to appear in the new year.<br><br>It's also worth mentioning that the International Accounting Standards Board expects to publish an exposure draft in January 2023 to introduce a temporary exception from accounting for deferred taxes arising from the implementation of the GloBE rules under Pillar Two and targeted disclosure requirements for affected companies. |
| **Zoe Andrews** | And that leaves me to wish you a happy Christmas and thank you for listening. If you have any questions, please contact Tanja or me, or your usual Slaughter and May contact. Further insights from the Slaughter and May Tax department can be found on the European Tax Blog – www.europeantax.blog. And you can also follow us on Twitter – @SlaughterMayTax. |